

**COORDINATED ISSUE
ALL INDUSTRIES
AMORTIZATION OF ORDER BACKLOG**

ISSUE:

To what extent can unfilled customer orders or contracts (order backlog) be amortized, and how can the useful life and value of the order backlog be determined?

BACKGROUND:

The order backlog issue arises primarily in the context of an acquisition of a manufacturing concern, although the issue may also be found in acquisitions of personal service or retail businesses. Stock and asset acquisitions involving issues concerning intangibles typically involve the payment of a premium over the net fair market value of the tangible assets of the acquired corporation or business.

To minimize the amount allocated to nonamortizable goodwill and going concern value, a taxpayer may allocate a large amount of the purchase price of the acquired concern to various intangible assets, and assign useful lives to these assets for purposes of claiming amortization under section 167. One such intangible asset which may be claimed is known as "order backlog." Order backlog represents the benefit derived from acquiring unfilled or incomplete customer orders or contracts for goods or services. An order backlog may consist of:

- * orders for which the manufacturing process has been completed but the orders have not been shipped as of the date of acquisition;
- * orders in the manufacturing stream that have not been completed as of the date of acquisition;
- * orders which have not been started in the manufacturing process as of the date of acquisition; or
- * purchase orders that have been placed by customers of a wholesaler or retailer which have not been filled because the wholesaler or retailer does not have the inventory on hand to complete the orders.

DISCUSSION:

The purpose of this paper is to explain how to examine a taxpayer's amortization claim relating to taxable periods prior to the effective date of I.R.C. § 197 (generally, August 10, 1993, unless an election is made for acquisitions occurring after July 25, 1991) or in cases in which the taxpayer has accepted an offer under the Intangibles Settlement Initiative. Historically, the Service took the position that order backlog was nonamortizable goodwill or going concern value. Unfilled customer orders allowed the buyer to step into the shoes of the seller, and contributed to the ability of the acquired business to continue to function and generate revenue without interruption as a result of the change in ownership. However, recent developments in the case law make it clear that the amortization of any intangible asset (including order backlog) is a question of fact, requiring both the Service and the taxpayer to develop the issue in terms of useful life and value. See Newark Morning Ledger Co. v. United States, 507 U.S. __, 113 S. Ct. 1670, 123 L.Ed.2d 288 (1993), rev'g 945 F.2d 555 (3d Cir. 1992), rev'g 734 F. Supp. 176 (D. N.J. 1990).

The Two-Prong Test for Amortization

Section 167(a) is the controlling provision for the allowance for amortization of intangible assets acquired prior to the enactment date (or election-back date, where applicable) of section 197.¹ Although section 167(a) does not specifically refer to intangible property, Treas. Reg. § 1.167(a)-3 recognizes that an intangible asset may be amortizable. Treas. Reg. § 1.167(a)-3 requires that the following factors be present before a deduction is allowable:

- * The intangible asset is known from experience or other factors to be of use in a trade or business or in the production of income for only a limited period of time, the length of which can be estimated with reasonable accuracy.

¹ "Depreciation" and "amortization" are used interchangeably. Generally, "depreciation" refers to an allowance for the wear, tear, exhaustion or obsolescence of a tangible asset. "Amortization" refers to the periodic recovery of the cost of an intangible asset. Both terms, however, describe the same cost recovery concept for which authority is found in section 167(a).

- * The deduction for depreciation is not for goodwill.

The regulation also provides that no depreciation deduction is allowable with respect to goodwill. By implication, this provision extends to going concern value as well. See United States v. Cornish, 348 F.2d 175 (9th Cir. 1965). Goodwill and going concern value are nondepreciable as a matter of law because of the difficulties inherent in the computation of their decline and because their initial value is difficult to appraise. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974); Dodge Brothers v. United States, 118 F.2d 95 (4th Cir. 1941); United States v. Cornish, 348 F.2d 175 (going concern value is nonamortizable as a matter of law). See also Southern Bancorporation v. Commissioner, 847 F.2d 131 (4th Cir. 1988). While goodwill and going concern value are often referred to conjunctively, they are different conceptually. Technically, "going concern value" represents the ability of a business to continue to function and generate income without interruption as a consequence of the change in ownership. Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 234 (1975). See also UFE, Inc. v. Commissioner, 92 T.C. 1314, 1323 (1989); Solitron Devices, Inc. v. Commissioner, 80 T.C. 1, 19-20 (1983), aff'd without published opinion, 744 F.2d 95 (11th Cir. 1984). Going concern value is "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern." VGS Corporation v. Commissioner, 68 T.C. 563, 591 (1977). Goodwill has been defined as "the expectancy of continued patronage." Boe v. Commissioner, 307 F.2d 339, 343 (9th Cir. 1962).

Given the definitions of goodwill and going concern value, the Service historically took the position that order backlog was nonamortizable as a matter of law. In the few reported cases addressing this asset, the courts viewed the amortization of unfilled customer contracts as a question of fact, with mixed results. Compare U.S. Industrial Alcohol Co. v. Commissioner, 42 B.T.A. 1323 (1943), aff'd in part and rev'd in part, 137 F.2d 511 (2d Cir. 1943) (concluding that customer orders were nonamortizable because they were "merely the current evidence of a continuing operation, the value of which is included in 'good- will'") with Business Service Industries, Inc. v. Commissioner, T.C. Memo. 1986-86 (customer contracts were amortizable, although court reallocated a portion of taxpayer's value to franchise).

However, the Service has modified its position as the result of the Supreme Court's opinion in Newark Morning Ledger Co. v. United States, supra. In Newark Morning Ledger, the Court held that

a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage.

113 S. Ct. at 1681 (emphasis supplied). The Supreme Court reasoned that if a taxpayer is able to establish that an intangible asset can be valued and that it has a reasonably estimable limited useful life, then the asset is necessarily separate and distinct from goodwill. "The entire justification for refusing to permit the depreciation of goodwill evaporates, however, when the taxpayer demonstrates that the asset in question wastes over an ascertainable period of time." 113 S. Ct. at 1680.

The opinion in Newark Morning Ledger is very broad and cannot be limited to customer based intangibles, nor should it be read as limited only to assets in the nature of goodwill. There is no legal justification for not extending the holding to assets in the nature of going concern value, as the Fourth Circuit recognized in Ithaca Industries, Inc. v. Commissioner, 17 F.3d 684 (4th Cir. 1994), aff'g 97 T.C. 253 (1991), cert. denied, 115 S. Ct. 83 (1994).

Application of Newark Morning Ledger to Order Backlog

Both prongs of the Newark Morning Ledger test are strictly factual determinations. For this reason, the Service has to factually develop cases involving order backlog in order to determine whether an amortizable asset exists. In Newark Morning Ledger, for example, the government did not challenge the taxpayer's factual evidence of useful life and value of the asset, relying instead on the argument that amortization should be disallowed as a matter of law because the "paid subscriber base" represented the goodwill of the acquired newspapers. The Supreme Court in holding for the taxpayer, noted that the task of the taxpayer was made significantly lighter by the government's failure to challenge the taxpayer's factual evidence.

However, the Newark Morning Ledger opinion makes it clear that a taxpayer claiming amortization of an intangible asset has a substantial burden to establish (1) that the taxpayer has accurately determined the duration of the claimed value of the asset, and (2) that the taxpayer has accurately determined its value.

The Supreme Court acknowledged that

Although we now hold that a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage, we do not mean to imply that the taxpayer's burden is insignificant. On the contrary, that burden will often prove too great to bear. Id. at 1681.

An unfilled customer order or contract may, in fact, have a limited useful life in the taxpayer's trade or business. Its benefit ends when the order has been filled or the

contracted-for services have been rendered.

Each unfilled order is an individual asset, and generally should be lifed separately from all other orders unless, as explained below, a grouping is more reasonable. Each unfilled order, however, should be valued separately from all other orders. Because the value of each order will vary depending on various factors including, inter alia, the favorableness of pricing, the quantity, and the term, valuation of all of a taxpayer's unfilled orders as a single asset could potentially distort the value of the order backlog intangible. The value of each contract for purposes of amortization is dependent upon the varying factors of each contract and therefore should be separately valued. See Ithaca Industries, Inc., supra. Since the valuation of order backlog is done on a contract by contract basis, and such contracts can have widely varying useful lives, we recommend that each contract be amortized separately so there is no distortion of income. However, it is noted that the Tax Court in Ithaca Industries, Inc. concluded that the taxpayer's use of a 14-month amortization period was a reasonable approximation of the useful life of the aggregated contracts where the latest termination date of any of the contracts at issue was 14 months after the merger date. Moreover, for certain order backlogs (retail customer orders), where the various factors are likely homogeneous, a grouping may be reasonable. We recognize that a taxpayer has authority under Treas. Reg. § 1.167(a)-7 to group similar contracts that have approximately the same life if there is no distortion of income. Thus, while order backlog contracts are preferably amortized separately, groupings of such contracts for amortization purposes are allowed where there is no distortion of income.

Not all order backlogs are capable of being lifed and valued. If there is any indication that a customer order or contract is not enforceable by either party, or that delivery or performance under the order or contract may not be completed, establishing a limited life and value for individual order backlogs may not be possible. Indeed, in this situation the order backlogs may have no value. As explained below, however, the fact that not all terms of the order are agreed to at the time of the purchase does not necessarily mean that the order contract is unenforceable. Some factors to consider in determining the enforceability of the order and the likelihood that it will be completed include:

- * How firm is the purchase order?
- * Is the price or delivery date fixed or left open?
- * Is it cancellable at will by one or both parties?
- * Is there a provision for a liquidated penalty or forfeiture of a deposit by the party who cancels the order?
- * What are industry practices and custom?

In considering how firm a purchase order is, keep in mind that under the Uniform Commercial Code certain key terms (including the price, see U.C.C. § 2-305) may be left open by the parties. Thus, if the terms are not fixed, you must look for additional factors to determine whether the order is enforceable. You may wish to consult District Counsel for an advisory opinion with respect to any order or contract that contains open-ended terms.

The following factors may be helpful in considering the likelihood that an order or contract will be filled:

- * Will the order be filled from inventory on hand, future inventory, or goods made to special order?
- * What are the prospects that the order will be cancelled by the customer?
- * What are the prospects that the taxpayer will be able to fill the order or perform under the contract within the period of time specified?
- * What is the industry practice or custom with respect to the types of orders at issue?

We note also that a group of retail customer orders, which are likely cancellable by either party, may have a determinable statistical life and a value. For example, the life would be based on the expected completion of the group's orders, and the value should reflect the probability of fulfillment of the orders, based on the taxpayer's experience.

Notwithstanding that a customer order is determined to be unenforceable, the contract may still provide an intangible benefit in the nature of customer relationship. Such customer relationship value is akin to the value inherent in acquired customer or subscription lists and may be determined pursuant to the expectancy of income, and valued and lived similar to customer or subscriber list intangibles. See the Customer List ISP Coordinated Issue Paper for a detailed discussion regarding amortization of a customer list intangible.

Valuation of Order Backlog

Assuming that an order backlog can be substantiated, the two most common and accepted methods of valuing the asset are the "avoided cost" method and the "income" (or "profit margin") method. Each unfilled customer order or incomplete contract should be valued individually.

The avoided cost method seeks to identify the costs which the taxpayer has avoided by purchasing a going concern with an order backlog. These costs will, in most cases, be limited to the selling expenses. The selling expenses include amounts that the

taxpayer would have expended to obtain the order or contract.

The income (or profit margin) method measures the net income to be derived from the order or contract. In determining the net income, all costs of completing the order -- both direct and indirect costs -- must be accounted for. If the taxpayer has only accounted for direct costs, the profit margin will be overstated. In addition to costs, other factors that would reduce the value (such as markdowns for high volume orders, discounts for payment in cash, etc.) should be included. In applying the income method, net income must be properly allocated to all operating assets, whether tangible or intangible, to avoid exaggerating net income attributable to the order backlog asset.

For guidance on valuing the inventory acquired that will be used to fill a taxpayer's order backlog, consult the ISP Coordinated Issue Paper on Valuation of An Acquired Retailer's Inventory.

Useful Life

Once the value of each order has been determined, its useful life must be established. Generally, the asset's useful life will be dictated by terms of the order concerning the delivery date or performance date. If the completion date is a term that is left open, useful life may be determined by industry experience, practice, or custom.

The useful life of each order should be determined, not the average life of all backlogged orders unless, as previously explained, a grouping is more reasonable.

Treatment of Market Based Intangibles Under Section 197

Amortization of order backlog will no longer be an issue for transactions occurring after August 10, 1993, the date of enactment of new Code section 197. Section 197 provides for 15-year straight line amortization of certain acquired intangible assets (called "amortizable section 197 assets") beginning with the month of acquisition. No other deduction for depreciation or amortization is allowed for amortizable section 197 assets. Except for a limited election for intangibles purchased after July 25, 1991, and before August 10, 1993, the legislation is not retroactive. The definition of "amortizable section 197 assets" includes assets resulting from the future provision of goods or services pursuant to customer relationships.

However, for taxable years after 1992, valuation will continue to be an issue. Taxpayers will have an incentive to overstate the values of tangible property with shorter recovery periods resulting in an understatement of the values of section 197 assets with longer 15-year amortization periods.

EXAMINATION POSITION:

In view of the Supreme Court's holding in Newark Morning Ledger, it is not appropriate to view order backlog as nonamortizable as a matter of law. Order backlog may be amortizable if, after factual development, the individual orders are shown to have limited useful lives and their individual values can be established with reasonable certainty.

Because a case involving order backlog requires factual development, examining agents are urged to consult a Service engineer or economist for lifing and valuation assistance. Although a taxpayer generally has the burden of proof with respect to the claimed useful life and valuation, the Service should always be able to specifically demonstrate why a taxpayer's appraisals or assertions are erroneous. General guidance on critiquing taxpayers' appraisals may be found in the Intangibles Settlement Initiative Teleconference Handbook, Internal Revenue Service Document 9233 (2-94), Catalog Number 20566N.